STATE OF VERMONT
PUBLIC SERVICE BOARD

Docket No. 7554

Investigation into Cooperative Electric Utilities' Accounting Treatment for Member Contributions-in-Aid-of-Construction for Line Extensions	)))

Order entered: 2/3/2011

ORDER ADOPTING CHANGE IN ACCOUNTING TREATMENT

I. INTRODUCTION

This docket is an investigation into cooperative utilities' accounting treatment for members' capital contributions for the construction of line extensions, commonly referred to as contributions-in-aid-of-construction ("CIAC"). Vermont Electric Cooperative, Inc. ("VEC") and Washington Electric Cooperative, Inc. ("WEC") currently treat CIAC in accordance with the terms of a 1973 Accounting Order issued by the Public Service Board ("Board") that allows electric cooperative utilities to record CIAC as "line-extension patronage capital"[1] (the "1973 Accounting Order"); this procedure is not consistent with Generally Accepted Accounting Principles ("GAAP") and the Federal Energy Regulatory Commission's ("FERC") Uniform System of Accounts.

In this proceeding, the Vermont Department of Public Service ("DPS") and VEC have agreed that VEC should: (1) record future CIAC in a manner consistent with GAAP; and (2) use the same method that VEC uses to allocate energy patronage capital to allocate the line-extension patronage capital currently shown on VEC's balance sheet to the energy patronage capital accounts of existing VEC members who use energy services in the calendar year in which the

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1. Traditionally, "patronage capital," also known as capital credits, refers to such amounts received and receivable from an electric cooperative's members for electric energy that are in excess of operating costs and expenses properly chargeable for the furnishing of that electric energy. All such amounts are received with the understanding that they are provided by the members as capital. Patronage capital becomes a cooperative utility's equity.

In this Order I refer to the traditional form of patronage capital as "energy patronage capital" to distinguish it from "line-extension patronage capital" which results from contributions in aid of construction for line extensions.

proposal is approved by the Board. The DPS has argued that WEC should also take these actions; WEC has opposed changing its current accounting treatment of CIAC.

In this Proposal for Decision, I recommend that the Board conclude that the accounting procedure approved in the 1973 Accounting Order for the treatment for CIAC should be discontinued by both VEC and WEC. I further recommend that the Board require VEC and WEC to record future CIAC in a manner consistent with GAAP and allocate all line-extension patronage capital currently shown on their balance sheets to their members' energy patronage capital accounts. However, in recognition of the two utilities' different circumstances, I recommend that the Board provide different implementation dates for each utility. Specifically, I recommend that the Board require VEC to begin recording future CIAC in a manner consistent with GAAP as of the date of the Board Order requiring the change and, at the end of 2011, to use the same method it employs to allocate energy patronage capital to allocate all line-extension patronage capital currently shown on its balance sheet to the energy patronage capital accounts of existing VEC members who use energy services in that year. I further recommend that the Board allow WEC to defer implementation of both changes for two years; under this recommendation WEC would begin recording future CIAC in a manner consistent with GAAP two years from the date of the Board order requiring the change and, at the end of 2013, WEC would use the same method it employs to allocate energy patronage capital to allocate all line-extension patronage capital currently shown on its balance sheet to the energy patronage capital accounts of existing WEC members who use energy services in that year.

II. Procedural History

On May 4, 2009, VEC and the DPS filed a settlement agreement in Docket 7488, an investigation into a rate increase request by VEC. In this settlement, VEC and the DPS agreed to a mechanism for changing the way that VEC accounts for the capital contributions from VEC customers for the construction of line extensions.

On June 10, 2009, WEC, which was not a party to Docket 7488, filed a letter with the Board expressing concern about the impact of the proposed change in accounting policy on cooperative electric utilities beyond VEC.

On July 31, 2009, the Board issued an Order in Docket 7488 stating that it would open a separate investigation into the accounting issues addressed in the settlement agreement in order to review more comprehensively the policy implications of the proposed accounting change for cooperative electric utilities in general.

On September 17, 2009, the Board opened this investigation and appointed me to serve as Hearing Officer.

On October 1, 2009, I held a prehearing conference.

On May 7, 2010, the DPS, VEC and WEC filed prefiled direct testimony. Attached to the DPS's prefiled direct testimony were exhs. DPS-RWB-1 and DPS-RWB-2. Attached to VEC's prefiled direct testimony were exhs. VEC-MLB-1 and VEC-MLB-2. Attached to WEC's prefiled direct testimony were exhs. WEC-1, WEC-2, WEC-3, WEC-4, WEC-5, WEC-6, WEC-7, WEC-8 and WEC-9. On May 14, 2010, I conducted a status conference. At the status conference, the parties stated their preference for resolving the issues in this proceeding on the basis of paper filings, without a technical hearing. Therefore, I hereby admit all of the parties' prefiled direct testimony and attached exhibits into evidence.[2]

On May 21, 2010, a memorandum was sent to the parties containing questions from the Board's staff regarding the proposed accounting treatment of CIAC that is at issue in this Docket.[3]

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2. Exhs. DPS-RWB-1 and WEC-1 are identical. In addition, exhs. DPS-RWB-2 and WEC-2 are identical. Nevertheless, I am admitting all four exhibits so that all references to these exhibits in prefiled testimony are clear.

Any party wishing to object to the admission into evidence of any of this prefiled direct testimony or attached exhibits should do so in its comments on this Proposal for Decision so that the Board may rule on any objections.

3. This memorandum stated that unless objections were filed by the parties, responses to these questions would be admitted into the record. The memorandum also asked if parties had any objections to the admission into evidence in this proceeding of the following documents that were originally filed in Docket 7488, with the understanding that if any of the factual information contained therein was updated in the prefiled testimony originally filed in Docket 7554, the updated information should be relied upon:

- Letter from Victoria J. Brown, Primmer Piper Eggleston & Cramer, PC, dated May 18, 2009, (hereinafter exh. VEC-4) with two attachments (Explanation of Patronage Capital (hereinafter exh. VEC-5) and a VEC Policy Statement concerning patronage capital (hereinafter exh. VEC-6));
- Prefiled Direct Testimony of Ron Behrns on behalf of the DPS, dated June 19, 2009 (hereinafter "Behrns 7488 pf."); and
- Supplemental Prefiled Testimony of Michael L. Bursell on behalf of VEC, dated June 19,

On June 11, 2010, VEC filed responses to the Board staff's questions. On June 14, 2010, the DPS and WEC filed separate responses to the Board staff's questions. As no party has objected to the admission of these responses into evidence, they are hereby admitted into evidence as exh. VEC-3, exh. DPS-3, and exh. WEC-14, respectively. I also admit into evidence WEC-10, WEC-11, WEC-12, and WEC-13, which were attached to exh. WEC-14.

On June 25, 2010, the DPS, VEC, and WEC separately filed replies to other parties' responses to the Board staff's questions. I am admitting these replies into evidence as exh. DPS-4, exh. VEC-7, and exh. WEC-15, respectively.[4]

On July 14, 2010, I sent a memorandum to the parties containing additional questions regarding a new option proposed by the DPS in its June 11 filing for eliminating the line-extension patronage capital that is currently shown on VEC's and WEC's balance sheets.[5]

On July 28, 2010, the DPS, VEC, and WEC filed responses to the questions in my July 14 memorandum. I hereby admit these responses into evidence as exh. DPS-5, exh. VEC-8, and exh. WEC-16, respectively.[6]

The DPS and WEC filed briefs on August 25, 2010, and August 27, 2010, respectively.

VEC and WEC filed reply briefs on August 31, 2010, and September 2, 2010, respectively.

2009 (without the exhibit that was attached to that testimony) (hereinafter "Bursell 7488 supp. pf.").

In their respective responses to the Board staff's questions, each party stated that it had no objection to the admission into evidence of the documents identified in the above bullets. Therefore, I am admitting these documents into evidence.

4. Any party wishing to object to the admission of exhs. DPS-4, VEC-7 or WEC-15 into evidence should do so in its comments on this Proposal for Decision so that the Board may rule on any objections.

5. In this memorandum, I noted that since it was possible that Board staff's questions and the parties' responses thereto could raise issues on which the parties would like to conduct cross-examination, the parties would have an opportunity to request a technical hearing. No party requested a technical hearing. Therefore, I did not hold a technical hearing in this proceeding.

6. Any party wishing to object to the admission of exhs. DPS-5, VEC-8 or WEC-16 into evidence should do so in its comments on this Proposal for Decision so that the Board may rule on any objections.

III. FINDINGS

Patronage Capital

1. Capital credits — also known as patronage capital — represent the amounts received and receivable from members of an electric cooperative utility for electric energy that are in excess of operating costs and expenses properly chargeable for the furnishing of electric energy. All such amounts are received with the understanding that they are furnished by the members as capital. Capital credits become a cooperative utility's equity. This equity makes it possible to secure loans and maintain facilities and services needed to deliver electricity to each member. Exh. VEC-5 at 1.

2. Electric cooperatives implement cooperative principles by, among other things, allocating capital credits to members each year and by "retiring" capital credits (returning them to members) when authorized, at the discretion of the utility's board of directors. Exh. VEC-6 at 1.

3. To qualify for federal tax-exempt status, a cooperative generally must allocate capital credits to patrons each year and maintain records sufficient to reflect the equity of each member in the assets of the cooperative. Audit guidelines issued by the Internal Revenue Service require a cooperative to allocate operating margins. A cooperative must keep adequate records of each member's rights and interest in the cooperative's assets, including capital credits balances and a history of patronage. Exh. VEC-6 at 1-2; Internal Revenue Service Code § 501(c)(12).

4. On or about May 4, 1973, the Board issued the 1973 Accounting Order allowing VEC and WEC to treat CIAC as patronage capital and to record it as retained earnings or equity. Under this accounting order, this patronage capital accrues to the individual paying the CIAC. Patt pf. at 4; exh. WEC-1; exh. DPS-RWB-1.

5. The accounting practice authorized by the 1973 Accounting Order was a departure from the GAAP that would have normally applied to payments for line extensions. Under both GAAP and the FERC Uniform System of Accounts, CIAC is to be charged to plant in service, thus reducing the original cost of the plant by the amount paid by the customer. Bursell pf. at 2; Behrns pf. at 7.

6. GAAP applies to companies of all sizes and compositions. Exh. DPS-3 at 7.

7. Title 7 of the Code of Federal Regulations Part 1767 is entitled "Accounting Requirements for [United States Department of Agriculture Rural Utilities Service ("RUS")] Electric Borrowers" and provides that:

> The electric plant accounts shall not include the cost or other value of electric plant contributed to the company. Contributions in the form of money or its equivalent toward the construction of electric plant shall be credited to accounts charged with the cost of such construction. Plant constructed from contributions of cash or its equivalent shall be shown as a reduction to gross plant constructed when assembling cost data in work orders for posting to plant ledgers of accounts. The accumulated gross costs of plant accumulated in the work order shall be recorded as a debit in the plant ledger of accounts along with the related amount of contributions concurrently be recorded as a credit.

Behrns pf. at 7; 7 C.F.R. § 1767.16(b)(4).

8. VEC and WEC appear to be the only two cooperative utilities in the country that use the accounting practice authorized by the 1973 Accounting Order. Bursell 7488 supp. pf. at 6; Behrns 7488 pf. at 11.

9. The purpose of the 1973 Accounting Order was to enable Vermont cooperative utilities to increase equity capital at a more rapid rate and to help reduce the need for future rate increases. Exh. DPS-RWB-1 at 2; exh. WEC-1 at 2.

10. The 1973 Accounting Order was reaffirmed in a January 6, 1983, letter from Board Chairman V. Louise McCarren to WEC's General Manager Robert Toombs (the "1983 Board Letter"). Patt pf. at 4; exh. WEC-2; exh. DPS-RWB-2.

VEC's Current Treatment of CIAC

11. VEC's accounting treatment of CIAC has been consistent with the Board's 1973 Accounting Order. When VEC receives member funds for line extensions, the following bookkeeping entries are made: (1) the contribution is entered as "received;" (2) the cash account is debited; and (3) a credit is entered for line-extension patronage capital. Bursell pf. at 2.

12. At the end of 2009, VEC's total equity was $39,181,966, which included $16,357,441 in line-extension equity. Bursell pf. at 2.

13. Since 1973, VEC has received line-extension patronage capital from approximately 10,000 members. Bursell 7488 supp. pf. at 1.

14. Approximately 2,000 current VEC members have "negative" line-extension equity because VEC's accounting treatment of CIAC differs from the manner in which Board Rule 3.700 addresses reimbursement of contributions from subsequent members who add on to the line extension. VEC credits CIAC to the original member who paid for the line extension; the original member remains the equity owner, even if the property is later sold. However, Board Rule 3.700 requires that a new member who requests a further line extension must pay a pro-rata share to the current owner of the initial residence, regardless of whether that person contributed the capital in the first place. In that case, the subsequent owner, who did not pay for the original line extension, receives a check from VEC out of proceeds received from the member who had requested the further line extension. As a result, the subsequent owner would have a negative equity balance since he or she did not pay for the original line extension. Bursell 7488 supp. pf. at 2-3.

15. VEC's Board of Directors has the discretion to determine the method, basis, priority and order of retirement of capital credits. VEC's Board of Directors may adopt procedures for the separate retirement of CIAC-related capital credits. Exh. VEC-6 at 3.

16. VEC has never returned any line-extension or energy patronage capital to customers. VEC believes its members generally have an understanding that energy patronage capital will be returned at some point, but do not expect that line-extension contributions will be returned. Bursell 7488 supp. pf. at 3-4.

17. A key measure for financial reporting in the utility industry is the equity ratio which is defined as equity divided by assets. Bursell pf. at 2.

18. VEC's Bylaws provide that patronage capital cannot be retired if, after the retirement, VEC's equity ratio would fall below 40 percent, except that patronage capital may be retired in any year when such a retirement will not cause total distributions of capital in that year to exceed 25 percent of the patronage capital or margins received in the prior year. Exh. VEC-5 at 1.

19. VEC's bond indenture requires a 25 percent minimum equity ratio. Bursell pf. at 2.

20. At the end of 2009, VEC's equity ratio was 38.4 percent. Bursell pf. at 2.

21. If VEC had followed GAAP rules by recording its members' line-extension contributions as a credit to plant, both VEC's equity and asset balances at the end of 2009 would

be reduced equally by $16,357,441 (the amount of line-extension equity), and VEC's equity ratio could be as low as 26.6 percent. Bursell pf. at 2.

WEC's Current Treatment of CIAC

22. WEC's accounting treatment for CIAC has been consistent with the 1973 Accounting Order. When WEC receives CIAC, it credits the respective member's capital credits account. Capital credits derived from CIAC are tracked separately from other capital credits earned by a member for patronage. The line extensions paid for by CIAC are listed as equity on WEC's financial records and become depreciable assets. Patt pf. at 5.

23. As of March 31, 2010, WEC's total equity was $17,236,323, which included $9,506,612 in line-extension equity. Patt pf. at 5; exh. WEC-5 at 2.

24. Since 1973, WEC has received line-extension patronage capital from approximately 3,000 of its members. Exh. WEC-14 at 3.

25. When a member who originally contributed line-extension capital sells his/her property, WEC transfers the recorded amount of line-extension equity associated with that property to the new owner. If, at a later date, another member wishes to extend the line, WEC offsets the amount of the refund provided to the new owner against that transferred equity. Therefore, "negative" line-extension equity is not a concern for WEC. Exh. WEC-14 at 3.

26. Pursuant to WEC's Bylaws, WEC's Board of Directors has the discretion to determine the method, basis, priority and order of retirement of capital credits. WEC's Bylaws allow WEC's Board of Directors to adopt rules providing for the separate retirement of CIAC-related capital credits. Patt pf. at 7; exh. WEC-4 at 3.

27. WEC began retiring capital credits by issuing capital credit refunds in 1998, and has continued to do so annually. WEC's Board of Directors annually adopts a plan for retiring capital credits. The plans are publicized and posted on WEC's website. Historically, the total annual refunds have been in the range of approximately $200,000-$275,000 per year and have been paid both to past and present members based upon their patronage for purchasing electricity. Refunds to current members are made as a credit on their bills. Patt pf. at 7.

28. To date, WEC's Board of Directors has never voted to authorize the retirement of any CIAC-related capital credits, and WEC has no immediate or anticipated plans to retire CIAC-related capital credits. WEC has not made any promises to its members, either individually or generally, about the retirement of CIAC-related capital credits. Patt. pf. at 7-8; exh. WEC-4 at 3.

29. WEC's loan covenants provide that capital credits cannot be retired if, after the retirement, WEC's equity ratio would fall below 30 percent, except that capital credits may be retired if, after the retirement, WEC's equity ratio would remain above 20 percent and the retirement would not cause total distributions of capital in that year to exceed 25 percent of the patronage capital or margins received in the prior year. WEC's Bylaws provide that capital credits cannot be retired unless, after the proposed retirement, WEC would have at least a 30 percent equity ratio. Patt pf. at 7; exh. WEC-4 at 3; exh. WEC-9 at 4.

30. As of March 31, 2010, WEC's equity ratio was approximately 30.2 percent. Patt pf. at 5; exh. WEC-5 at 2.

Docket 7488 Memorandum of Understanding

31. The Docket 7488 Memorandum of Understanding between the DPS and VEC ("Docket 7488 MOU") provides for VEC to stop recording CIAC as line-extension patronage. Instead, consistent with current FERC and GAAP accounting requirements, VEC would credit the work-order plant accounts for the project that the contributions were intended to offset. Under the terms of the Docket 7488 MOU, while the work order is open, the line-extension contributions would be recorded as construction work in progress. When the work order is closed to plant in service, the line-extension contribution amounts would be applied as credits to the plant accounts with such amounts flowing through the work-order control process. Exh. WEC-3 at 4.

32. Under the Docket 7488 MOU, VEC's CIAC bookkeeping procedures would be as follows: (1) enter the contribution as "received"; (2) debit the cash account; (3) apply cash received to the line-extension work order; and (4) credit the work order. Bursell pf. at 3.

33. The Docket 7488 MOU provides that VEC would write off line-extension patronage equity which is already accumulated on VEC's balance sheet, but only to the extent that VEC's equity as a percentage of total assets has increased by more than 0.50 percent on a calendar-year

basis from the previous calendar year. The Docket 7488 MOU further provides that if VEC's equity-to-asset ratio reaches or exceeds 40 percent in any calendar year, VEC would write off all excess equity; however, in VEC's discretion, in lieu of writing off line-extension patronage equity, VEC could return up to 50 percent of excess equity to its members as a refund of energy patronage equity. Exh. WEC-3 at 4-5.

Alternative Option for Addressing Historical Line-extension Equity

34. An alternative option for addressing historical line-extension equity would be for VEC and WEC to allocate the historical line-extension equity to their contributing members, using the same method as the cooperative uses to allocate energy patronage capital, at the end of the year in which the change in accounting for line-extension contributions takes effect. For VEC, this would mean allocating the historical line-extension patronage capital on a pro-rata basis to its contributing customers. Exh. VEC-7 at 1; exh. DPS-3 at 5.

35. This alternative approach would have the following benefits, when compared to the approach set forth in the Docket 7488 MOU: (1) it preserves the intent of the Board to allow Vermont cooperative utilities to raise equity as contemplated in the 1973 Accounting Order and the 1983 Board Letter; (2) it immediately removes all line-extension patronage capital by converting it to patronage capital that is shared by those who are paying for the line extensions through depreciation expense; (3) it leaves existing plant balances intact and avoids the necessity and complexity of trying to determine past retirements and current net book values for existing line extensions; and (4) it continues and supports the Board policy that growth pays for growth in that the line-extension patronage capital will no longer exist as such and would no longer be subject to refund or retirement. Exh. DPS-3 at 6.

36. Transferring equity from the line-extension equity holders to the capital accounts of existing cooperative members would not raise any new issues under GAAP. Exh. VEC-8 at 2.

Concerns Regarding Current Treatment of CIAC

37. It is a longstanding Vermont regulatory policy that a customer who requests electricity service should bear the full costs of providing that service, and that these costs should not be

spread among other existing ratepayers. This policy is often summarized as "growth pays for growth." Behrns pf. at 5; Docket 5496, *Board Investigation into Electric Distribution Line Extension Policies for the Purpose of Developing Board Rules Related to Line Extensions*, Order of 4/11/91 at 8.

38. Under VEC's and WEC's current treatment of CIAC, their existing customers immediately begin paying for the new line through depreciation expense, maintenance, and taxes. This places the costs of providing the new service on existing ratepayers. Behrns pf. at 5.

39. Under VEC's and WEC's current treatment of CIAC, unless the new customer's CIAC is returned to the customer, customers end up paying twice for the new line. The initial customer paid once through CIAC and all other customers, including the initial customer, will pay again for the same plant through the recovery of depreciation expense that is included in the cooperative's cost of service. Behrns pf. at 6.

40. It is transparent, fair and reasonable for a cooperative to collect equity capital from all of its owners, not just those few who happen to need facilities built at the time the company needs equity. Behrns pf. at 5.

41. In 1982, the Rural Electrification Administration ("REA"),[7] one of WEC's lenders, informed WEC that it considered WEC's accounting with respect to CIAC to be "inequitable." REA further stated that WEC either needed to obtain written authorization from the Board "for this accounting departure from a generally accepted industry practice" or WEC must change its accounting practice. Exh. WEC-13 at 2-3.

42. WEC's two lenders, National Rural Cooperative Finance Corporation ("CFC") and RUS, have conducted annual audits and/or reviews of WEC's finances since 1973. Both lenders continue to provide long-term financing for WEC's Construction Work Plans and generation projects, as well as short-term lines of credit. WEC is not aware of RUS or CFC staff members having raised concerns about CIAC during the course of WEC's regular and frequent contact with them. Patt pf. at 6; exh. WEC-14 at 4.

7. REA is the former name of RUS. Patt pf. at 6.

Concerns Regarding Changing Current Treatment of CIAC

43. Maintaining healthy equity levels is necessary for a cooperative to effectively operate as an electric utility and serve its members. Patt pf. at 9.

44. The current treatment of CIAC has allowed WEC to develop healthy equity levels. CIAC continues to represent a significant portion of WEC's annual margins. Patt pf. at 9; exh. WEC-6.

45. Absent CIAC equity, WEC may need to increase rates to raise additional revenue to meet lender requirements. Patt pf. at 10.

46. In the absence of CIAC equity (and correspondingly higher rates to make up for the loss), WEC's remaining equity level would be extremely low and would send a signal to its lenders that its financial health is compromised. Patt pf. at 9.

47. Even without the change in accounting treatment for CIAC, WEC expects to be facing double-digit rate increases starting in 2011.[8] Patt pf. at 9-10; exh. WEC-8.

48. The following characteristics distinguish WEC from other Vermont utilities and the industry generally, especially when considered in combination:

- WEC has the lowest customer density of any Vermont utility with 8 meters per mile.
- Approximately 98 percent of WEC's accounts are residential or seasonal residential.
- Approximately 90 percent of WEC's load is residential or seasonal residential. In 2008, WEC ranked 15th highest among all 864 distribution cooperatives nationally in residential sales as a percent of total sales.
- WEC's average residential usage, at approximately 520 kWh/month, is below the Vermont state average of 581 kWh/month, the national average for all utilities of 920 kWh/month, and the national average for rural electric cooperatives of 1,150 kWh/month.
- Consistent with WEC's density and low usage per meter, WEC's revenue per mile is extremely low.

Exh. WEC-14 at 2.

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8. On November 15, 2010, WEC filed a request for a 23.81 percent rate increase, to take effect on January 1, 2011. The Board is investigating this request in Docket 7691.

49. Significantly reducing VEC's equity-to-asset ratio would put VEC at risk of violating its bond covenants. Such a reduction would almost certainly be perceived as negative from the rating agencies and potential power supply contract partners. Bursell 7488 supp. pf. at 5.

50. When evaluating VEC's financial strength, rating agencies, banking partners and suppliers have sometimes made adjustments to VEC's equity ratio to factor in GAAP accounting with respect to the line-extension equity that VEC has shown on its balance sheet. These partners have not expressed any concerns regarding changing the current treatment of CIAC as provided in the Docket 7488 MOU. Bursell pf. at 5.

IV. Discussion

In 1973 the Board authorized VEC and WEC to record CIAC as line-extension patronage capital, a procedure that is not consistent with GAAP or the FERC Uniform System of Accounts. The Board's rationale was to "allow the Cooperatives to increase equity capital at a more rapid rate and . . . help reduce the need for rate increases in the future."[9] The two key issues before me in this proceeding are: (1) whether to allow WEC and VEC to continue this unusual accounting treatment, or to require them to follow a procedure for recording CIAC that complies with GAAP; and (2) how to account for the line-extension patronage capital currently recorded on the balance sheets of the affected cooperative utilities.

VEC and the DPS agree that VEC should change its procedures to be compliant with GAAP.

The DPS argues that WEC should also change its procedures because the current practice is inconsistent with the long-standing state policy that "growth pays for growth." WEC disagrees, noting that the 1983 Board Letter states, in part:

> In 1973, the Board's policy was that growth pays for growth. We believe that the accounting treatment approved in May, 1973, accomplishes this and provides the Cooperative with needed equity and the necessary funds through depreciation to repay the consumers that contributed equity funds.[10]

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9. Exh. DPS-RWB-1 at 2; exh. WEC-1 at 2.

10. Exh. DPS-RWB-2; exh. WEC-2.

I recommend that the Board conclude that VEC and WEC's current treatment of CIAC is not consistent with Vermont's growth-pays-for-growth policy. The evidence in this proceeding demonstrates that the treatment is not consistent with this policy for two reasons. First, because the CIAC is not used to reduce the original cost of the plant, all ratepayers pay depreciation on the new line extension. Second, even though neither VEC nor WEC has ever returned any line-extension patronage capital to their ratepayers, both the original 1973 Accounting Order and the 1983 Board Letter clearly state that the member paying the CIAC is entitled to be repaid those funds at some point in time.[11] By definition, this is inconsistent with the growth-pays-for-growth policy, regardless of whether VEC and WEC have any immediate — or even anticipated — plans for returning such funds. I recognize that the 1983 Board Letter states that the accounting treatment approved in May 1973 was consistent with the growth-pays-for-growth policy; however, the letter does not explain the basis for this statement and, in my judgment, the statement by itself does not outweigh the evidence to the contrary presented in this Docket.

WEC argues that it should be allowed to continue to use the current accounting treatment because the policy rationale — to increase equity capital at a more rapid rate — is still valid. According to WEC, this accounting treatment allowed WEC to develop healthy equity levels, thereby contributing significantly to the strengthening of its financial situation. WEC contends that it continues to face "ongoing economic disadvantages"[12] that can be partially mitigated by continuing the current accounting treatment since it helps WEC maintain healthy equity levels. WEC adds that, without such equity levels, its financial health would be compromised, likely resulting in higher interest rates and possibly precluding WEC from obtaining necessary financing in the future.

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11. The 1973 Accounting Order states "the member would eventually get back the capital he has contributed toward his line extension." Exh. DPS-RWB-1 at 2; exh. WEC-1 at 2. The 1973 letter from VEC to the Board states that a member paying CIAC "will have the knowledge that at some future time he will be entitled to have this patronage returned." Exh. DPS-RWB-1 at 1; exh. WEC-1 at 1.

The excerpt from the 1983 Board Letter quoted above refers to repaying the consumers who contributed equity funds. Exh. DPS-RWB-2; exh. WEC-2.

12. WEC Brief at 4. *See* finding 48, above, for a list of these claimed economic disadvantages.

I agree with WEC that it is important for an electric utility to maintain healthy equity levels. However, the issue before me is not whether a utility should maintain such equity levels, but rather, *how* the utility should do so. The traditional method for a cooperative to maintain such equity levels is through Times Interest Earned Ratio ("TIER") earnings, rather than by recording CIAC as line-extension equity. Using the traditional method, if a cooperative needs additional member equity to finance its ongoing operations beyond that which the utility's income level at the time provides, transparent equity infusions can be included in a cost of service through a higher TIER or a TIER adder and presented to the members as such. Under this method, all of a cooperative's current members would be contributing additional equity. This traditional method is consistent with GAAP, which applies to companies of all sizes and compositions, including cooperative utilities facing "ongoing economic disadvantages." WEC has presented neither compelling evidence nor a persuasive argument for why it would not be appropriate for WEC to utilize the traditional TIER method.

At the time the Board issued the 1973 Accounting Order, WEC had "extremely low equity with some of the highest electric rates in the State."[13] The accounting order did allow VEC and WEC to increase their equity at a faster rate than they otherwise would have without additional rate increases. However, today both VEC and WEC have sufficient equity to comply with their lenders' requirements.[14] As a result, I conclude that the current accounting treatment's original policy rationale — to increase equity capital at a more rapid rate — is insufficient to justify the treatment's failure to comply with GAAP and Vermont's growth-pays-for-growth policy.

For the reasons set forth above, I recommend the Board direct VEC and WEC to discontinue the use of the accounting procedure approved in 1973 for the treatment for CIAC, and instead require both utilities to record future CIAC in a manner consistent with GAAP. However, I further recommend that the Board consider each utility's individual circumstances when determining the effective date for this accounting change.

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13. Patt pf. at 8.

14. *See*, findings 19-20 and 29-30, above.

VEC's execution of the Docket 7488 MOU indicates that VEC is able to begin recording future CIAC in a manner consistent with GAAP as of the date of a Board order in this proceeding approving such a change; I, therefore, recommend the Board require this.

WEC argues that, if the Board discontinues the use of the accounting procedure approved in 1973, then WEC should be allowed to implement such a change prospectively over time to minimize any rate pressure resulting from the accounting change. Specifically, WEC requests that any change not take effect for two years. The evidence in this case is unclear regarding the potential rate impact of the discontinuation of the current accounting procedure for CIAC. WEC has estimated it would need an increase of approximately 2.75 percent to raise an additional $300,000 in equity each year if the accounting procedure were changed.[15] However, this projection does not reflect a concommittant reduction in depreciation expense that would occur if the accounting procedure were changed;[16] there is no evidence in this proceeding regarding the magnitude of this depreciation expense reduction, or to what extent it would offset any need to increase rates to raise additional equity. Nevertheless, in light of WEC's pending request for a 23.81 percent increase, effective January 1, 2011, I find it would be reasonable for the Board to allow WEC two years to incorporate the effect of the accounting change into its financial operations. Therefore, I recommend that the Board require WEC to record future CIAC in a manner consistent with GAAP, commencing two years from the date of the Order requiring the change.

I now turn to the issue of how to treat the line-extension patronage capital currently recorded on WEC's and VEC's balance sheets. VEC and the DPS originally agreed in the Docket 7488 MOU to a method for writing off such line-extension patronage capital over a period of time, as VEC's financial situation permits. Subsequently, in this proceeding, the DPS and VEC have agreed to an alternative method — using the same method that VEC uses to allocate energy patronage capital, allocate all historical line-extension patronage balances to the energy patronage accounts of existing VEC members who use energy services in the calendar year in

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15. Exh. WEC-8.

16. Exh. WEC-14 at 3.

which the proposal is approved by the Board.[17] The DPS and VEC agree that this method is preferable, for the reasons set forth in finding 35, above.

The DPS argues that WEC also should reallocate its historical line-extension patronage balances to the energy patronage accounts of current WEC patronage capital holders. The DPS states that it is willing to work with WEC to the extent necessary to tailor any implementation details to WEC's specific circumstances.[18]

WEC argues that the Board should not retroactively alter the equity previously accrued by WEC under the 1973 Accounting Order. WEC contends that, if the Board alters the equity WEC previously accrued, it may have to raise rates to capture expenses that have occurred in years past (e.g., the CIAC contributions and equity for line extensions that previously occurred). According to WEC, that would be retroactive ratemaking (the establishment of rates at a level that permits the recovery of past losses) which is prohibited in Vermont. In addition, WEC asserts that any retroactive change to accrued equity would cause a "manifest injustice" due to WEC's reasonable reliance upon the accounting order and the expected economic harm that would follow from retroactive application. According to WEC, this would violate the principle that an administrative agency's adjudicative decision should not be applied retroactively where substitution of new law for old law would not protect settled expectations. Nevertheless, if the Board decides to adjust WEC's equity retroactively, WEC requests that the approach agreed to by

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17. I note that there is a slight difference between the DPS-VEC agreement as described in exhs. VEC-7, VEC-8 and DPS-5 and proposed finding 8 in the DPS's Brief, which cites exh. DPS-3. Exh. VEC-7 states that the DPS and VEC have agreed that the existing line-extension patronage capital should be allocated to "contributing customers" while the DPS's Brief proposes a finding in which the existing line-extension patronage capital would be allocated to "all existing patronage capital holders." Because VEC has never retired energy patronage capital, I expect that some of the owners of VEC's energy patronage capital are no longer contributing customers (e.g., former customers who have moved out of VEC's service territory).

In this Proposal for Decision, I treat the agreement as stated in exhs. VEC-7, VEC-8 and DPS-5 as a refinement to the alternative approach first described in the DPS's June 14, 2010, filing (exh. DPS-3) because, according to exh. VEC-7, the mechanism described therein was the result of discussions subsequent to the DPS's June 14, 2010, filing (exh. DPS-3). In addition, I note that, as stated in finding 35, above, one of the benefits of this alternative approach to the elimination of all line-extension patronage capital is that it converts it to patronage capital that is shared by those who are paying for the line extensions through depreciation expense. Only contributing customers are continuing to pay depreciation expense, so it is appropriate to limit the allocation of line-extension patronage capital to these customers.

18. Exh. DPS-5 at 2.

VEC and the DPS be utilized where line-extension patronage capital is converted to energy patronage capital.[19]

After reviewing the evidence in this proceeding regarding the two alternative approaches for eliminating the line-extension patronage capital currently on VEC's and WEC's balance sheets, I conclude that the better approach is to allocate all historical line-extension patronage balances to members' energy patronage accounts. All three parties prefer this approach to the approach set forth in the Docket 7488 MOU. In addition, this allocation approach preserves the original intent of the 1973 Accounting Order (to increase the cooperatives' equity) and is much simpler to administer.

Furthermore, WEC's arguments regarding retroactive ratemaking do not apply to the conversion of current line-extension patronage capital to energy patronage capital. WEC's arguments are premised on the presumed need to increase its rates to raise additional equity if the Board altered the amount of equity WEC previously accrued. However, under the approach agreed to by VEC and the DPS in this proceeding, the total amount of equity on WEC's balance sheet would remain the same; there would be no need for WEC to raise rates as a result of the conversion of line-extension patronage capital to energy patronage capital. It follows, then, that WEC's concerns regarding retroactive ratemaking are moot.

VEC and the DPS have agreed upon some implementation details regarding this alternative approach. Specifically, VEC and the DPS have agreed that the historical line-extension patronage balances should be allocated to the energy patronage accounts of existing VEC and WEC members who use energy services in the calendar year in which the proposal is approved by the Board (rather than all VEC owners of energy patronage capital). In addition, VEC and the DPS have agreed that this allocation should be made using the same method as VEC uses to allocate energy patronage capital (a pro-rata basis), and that the allocation should occur at the end of the year in which the Board requires the change in accounting for CIAC. I recommend the Board conclude that this is a reasonable method for implementing the alternative approach to eliminating historical line-extension patronage capital balances, and direct WEC to follow it as well.

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19. WEC Brief at 6-7.

Therefore, I recommend that the Board direct VEC to use the same method it employs to allocate energy patronage capital to allocate all historical line-extension patronage balances to the energy patronage accounts of existing VEC members who use energy services in the calendar year in which the proposal is approved by the Board at the end of that year. Because I recommend that WEC be allowed to continue the current accounting treatment of CIAC for two years after the date of a Board order approving the change, I recommend that the Board allow WEC to delay the allocation of existing line-extension patronage capital, using the same method it employs to allocate energy patronage capital, until the end of the year in which it stops recording CIAC as line-extension equity (2013). This delay is appropriate so that WEC will only need to perform one allocation of line-extension patronage capital. This delay will also allow WEC sufficient time to provide an appropriate explanation of the allocation to its members, an issue that is important to WEC because of the potential for member confusion regarding the resulting larger-than-usual increase in their energy patronage capital accounts.[20]

Finally, the DPS recommends that the Board require VEC and WEC to file proposals for new accounting procedures that comply with FERC and RUS accounting standards and state policy regarding payment for new growth-related electric plant. VEC states that it is willing to submit the proposed new accounting procedures for final Board review, as the DPS recommends, but asserts that the Board need not approve the procedures because they are consistent with GAAP, FERC and RUS accounting standards.

The Board typically does not approve utility accounting procedures unless they represent a deviation from GAAP and FERC accounting standards. Instead, under the traditional regulatory structure, utilities are expected to implement accounting procedures that comply with those standards, and the DPS may review any of a utility's accounting procedures in the course of its regulatory activities. The DPS may bring any concerns regarding a utility's accounting practices to the Board's attention at any time. I recognize that the DPS is essentially asking the Board to require VEC and WEC to make a compliance filing in this proceeding. However, given that the Board is not directing the utilities to implement a special accounting treatment, but rather, to return to standard accounting procedures, I do not find such a compliance filing to be

20. *See*, exh. WEC-16 at 2.

necessary in this instance. Therefore, I decline to recommend that the Board require VEC and WEC to file proposals for new accounting procedures that comply with GAAP, FERC and RUS accounting standards.

V. Conclusion

For the reasons set forth above, I recommend that the Board conclude that the accounting procedure approved in 1973 for the treatment for CIAC should be discontinued by both VEC and WEC. I further recommend that the Board require VEC and WEC to record future CIAC in a manner consistent with GAAP and allocate all line-extension patronage capital currently shown on their balance sheets to all of their members' energy patronage capital accounts. However, in recognition of the two utilities' different circumstances, I recommend that the Board provide different implementation dates for each utility. Specifically, I recommend that the Board require VEC to: (1) begin recording future CIAC in a manner consistent with GAAP as of the date of the Board Order approving the change; and (2) at the end of 2011, use the same method VEC uses to allocate energy patronage capital to allocate all line-extension patronage capital currently shown on its balance sheet to the energy patronage capital accounts of existing VEC members who use energy services in that year. I further recommend that the Board allow WEC to defer implementation of both changes for two years; under this recommendation WEC would begin recording future CIAC in a manner consistent with GAAP two years from the date of the Board order requiring the change and, at the end of 2013, WEC would use the same method it uses to allocate energy patronage capital to allocate all line-extension patronage capital currently shown on its balance sheet to the energy patronage capital accounts of existing WEC members who use energy services in that year.

Dated at Montpelier, Vermont, this 1st day of February, 2011.

s/ Ann Bishop
Ann Bishop
Hearing Officer

VI. Board Discussion

On January 28, 2011, the DPS and WEC separately filed comments on the Hearing Officer's Proposal for Decision. No other party filed comments.

The DPS supported the Proposal for Decision.

WEC also supported the Proposal for Decision with one minor alteration and the correction of a typographical error.[21] WEC requested that the implementation date for changing its accounting treatment of CIAC be January 1, 2013, to correspond with its fiscal year, rather than two years after the date of a Board order approving the change as proposed by the Hearing Officer. WEC stated that this change in date would promote administrative efficiencies for WEC and its members.

We conclude that WEC's requested modification to the implementation date for changing its accounting methods is reasonable. It is slightly earlier than that proposed by the Hearing Officer and will be administratively more efficient. Therefore, commencing on January 1, 2013, WEC shall change its accounting treatment of CIAC in the manner described in the Proposal for Decision.

VII. Order

It Is Hereby Ordered, Adjudged and Decreed by the Public Service Board of the State of Vermont that:

1. The findings and conclusion of the Hearing Officer are adopted, except that Washington Electric Cooperative, Inc. ("WEC") shall implement the change in accounting treatment described in Order Paragraph 4, below, commencing on January 1, 2013.

2. As of the date of this Order, Vermont Electric Cooperative, Inc. ("VEC") shall discontinue the accounting treatment for Contributions-in-Aid-of-Construction ("CIAC") approved in the Public Service Board's ("Board") 1973 Accounting Order, and shall record future CIAC in a manner consistent with Generally Accepted Accounting Principles ("GAAP").

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21. The last sentence of the Proposal for Decision's Conclusion included a reference to VEC members that should have been WEC members. This typographical error has been corrected.

3. At the end of 2011, VEC shall use the same method it employs to allocate energy patronage capital to allocate all line-extension patronage capital currently shown on its balance sheet to the energy patronage capital accounts of existing VEC members who use energy services in that year.

4. Commencing January 1, 2013, WEC shall discontinue the accounting treatment for CIAC approved in the Board's 1973 accounting order, and shall record future CIAC in a manner consistent with GAAP.

5. At the end of 2013, WEC shall use the same method it employs to allocate energy patronage capital to allocate all line-extension patronage capital currently shown on its balance sheet to the energy patronage capital accounts of existing WEC members who use energy services in that year.

6. This docket shall be closed.

Dated at Montpelier, Vermont, this 3rd day of February, 2011.

s/ James Volz	)	
	)	PUBLIC SERVICE
	)	
s/ David C. Coen	)	BOARD
	)	
	)	OF VERMONT
s/ John D. Burke	)	

OFFICE OF THE CLERK

FILED: February 3, 2011

ATTEST: s/ Judith C. Whitney
Deputy Clerk of the Board

NOTICE TO READERS: This decision is subject to revision of technical errors. Readers are requested to notify the Clerk of the Board (by e-mail, telephone, or in writing) of any apparent errors, in order that any necessary corrections may be made. (E-mail address: psb.clerk@state.vt.us)

Appeal of this decision to the Supreme Court of Vermont must be filed with the Clerk of the Board within thirty days. Appeal will not stay the effect of this Order, absent further Order by this Board or appropriate action by the Supreme Court of Vermont. Motions for reconsideration or stay, if any, must be filed with the Clerk of the Board within ten days of the date of this decision and order.